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College Saving Options

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College costs

For the 2018/2019 college year, the average annual cost of attendance (known as the COA) at a four-year public college for in-state students is $25,890, the average cost at a four-year public college for out-of-state students is $41,950, and the average cost at a four-year private college is $52,500. The COA figure includes tuition and fees, room and board, books and supplies, transportation, and personal expenses. Many private colleges cost substantially more. (Source: The College Board's 2018 Trends in College Pricing Report.)

College savings options

It is important for parents to start putting money aside for college as early as possible. But where should you put your money? There are many possibilities, each with varied features. For example, some options offer tax advantages, some are more costly to establish, some charge management fees, some require parental income to be below a certain level, and some impose penalties if the money is not used for college.

Following is a list of options:

- 529 savings plans
- 529 prepaid tuition plans
- Coverdell education savings accounts
- Custodial accounts (UTMA/UGMA)
- Mutual funds/brokerage account
- Certificates of deposit (CDs)
- U.S. savings bonds
- Traditional IRAs and Roth IRAs
- Employer-sponsored retirement plans
- Employee stock purchase plans
- Cash value life insurance
- Tax-deferred annuities
- Options unique to business owners

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. As with other investments, there are generally fees and expenses associated with participation in a 529 savings plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated.*

Factors that may affect college savings decisions

When investing for college, there are several factors to consider.

Tax advantages

Money saved for college goes a lot further when it's allowed to accumulate tax free or tax deferred. To come out ahead in the college savings game, it's wise to consider tax-advantaged strategies.

Example: *Assume that every year you put money away in a non tax-advantaged investment that earns 9 percent. If your earnings are subject to a 33 percent tax rate (federal and state), your after-tax return is 6 percent.*

Example: *Now assume you put the same amount of money every year into a tax-advantaged vehicle, such as a 529 plan that earns 9 percent per year. If you later withdraw the money to pay qualified education expenses, you have no tax liability. So, your*

after-tax return is 9 percent.

The result is that in some cases your return can be greater with a tax-advantaged strategy like a 529 plan than with an investment that offers no special tax advantages (although there is no guarantee that an investment will generate any earnings).

Kiddie tax

Many parents believe they can shift assets to their child in order to avoid high income taxes. But if the child is under age 24, the "kiddie tax" rules apply.

The basic tax rules are as follows:

- For children age 18, or under age 24 if a full-time student, the first $1,050 of annual unearned income (e.g., interest, dividends, capital gains) is tax free, the second $1,050 is taxed at the child's rate, and any unearned income over $2,100 is taxed at trust and estate tax rates.

Tip: *One way parents may avoid the kiddie tax is to put their child's savings in tax-free or tax-deferred investments so that any taxable income is postponed until after the child reaches age 24 (when the child is taxed at his or her own rate). Such investments can include U.S. savings bonds or tax-free municipal bonds. Alternatively, parents can try to hold just enough assets in their child's name so that the investment income remains under $2,100.*

Financial aid

Whether or not a child will qualify for financial aid (e.g., loan, grant, scholarship, or work-study) may affect parental savings decisions. The majority of financial aid is need-based, meaning that it's based on a family's ability to pay.

Predicting whether a child will qualify for financial aid many years down the road is an inexact science. Some families with incomes of $120,000 or more may qualify for aid, while those with lesser incomes may not. Income is only one of the factors used to determine financial aid eligibility. Other factors include amount of assets, family size, number of household members in college at the same time, and the existence of any special personal or financial circumstances.

If a child is expected to qualify for financial aid (and most do), parents should be aware of the formula the federal government uses to calculate aid--called the federal methodology--because there can be a financial aid impact on long-term savings decisions. The more money a family is expected to contribute to college costs, the less financial aid a child will be eligible for.

Briefly, under the federal methodology, parents are expected to contribute 5.6 percent of their assets to college costs each year, and students are expected to contribute 20 percent of their assets each year.

Example: *A sum of $20,000 in your child's savings account would translate into a $4,000 expected contribution ($20,000 x 0.20), but the same money in your account would result in a $1,120 expected contribution ($20,000 x 0.056).*

Also, the federal methodology excludes some parental assets from consideration in determining a family's total assets:

- Retirement accounts (e.g., IRA, 401(k) plan, 403(b) plan)
- Home equity in a primary residence or family farm
- Cash value life insurance
- Annuities

Thus, all options being equal, parents may choose to put their money into one or more of these nonassessable assets.

Caution: *Although the federal government excludes these assets, individual colleges have discretion whether to consider them in determining a family's ability to pay college costs.*

Time frame

Time frame is a very important consideration. Is the child in preschool or a freshman in high school? Obviously, most college savings strategies work best when the child is many years away from college. With a longer time horizon, parents can be more aggressive in their investments and have more years to take advantage of compounding.

When the child is a baby up until about middle school, most professional financial planners recommend putting more money into equity investments because historically, over the long term, equities have provided higher returns than other types of investments (though past performance is no guarantee of future results). Then, as the child moves from middle school to high school, it's

usually wise for parents to start shifting a portion of their equities toward shorter-term, fixed income investments.

If the time frame is only a few years, parents will be limited in their choice of appropriate strategies. For example, if the child were in high school, equities normally would not be a preferred strategy due to the short-term volatility of these investments. Similarly, parents would not have enough time to build up cash value in a life insurance policy.

Flexibility

With some college savings options, parents will pay a penalty if the funds aren't used for college. Other options have no such restrictions on the use of funds.

Control issues

Generally, when parents give money or property to their child, they lose control of those assets. Such a loss of parental ownership can take place immediately, as in the case of an outright gift of stock certificates, or it may be delayed, as in the case of a custodial account or trust. In any event, parents must assess their personal feelings about relinquishing control of assets to their child. Some children may not be mature enough to handle such assets, whereas others can be counted on to use them for college costs.

Discussing a college funding plan with your child

As college expenses continue to rise relative to the means of the average family to pay such costs in full, parents may find it helpful to sit down with their older children and discuss ways to pay for college. For example, parents may want to discuss:

- Whether they intend to fund 100 percent of college costs or whether they expect their child to contribute and, if so, in what amount. For example, parents might convey their expectation that their child contribute a certain percentage of all earnings from a part-time job or a portion of all gifts.
- Whether the child will play a role in the savings strategy. For example, parents who want to gift appreciated stock to their child should convey their expectation that the child will apply all of the gains to college costs.
- Whether any money will need to be borrowed, and if so, how much and in whose name the loan(s) will be obtained. The amount that needs to be borrowed may affect the type of college the child applies to (e.g., public or private, top tier or middle tier).
- Whether there will need to be shared financial responsibility during the college years. For example, the child may need to participate in a work-study program or obtain outside work during the college years.

Communicating these expectations ahead of time can prevent unpleasant surprises and help parents and their children better plan for the expenses that lie ahead. Also, an open discussion can give children an increased awareness of the financial burden their parents may be undertaking on their behalf.

Dilemma of saving for college and retirement

For many parents, especially those who started families in their 30s and 40s, the problem of saving for college and retirement at the same time is a nagging reality. Most financial planning professionals recommend saving for both at the same time. The reason is that parents typically can't afford to delay saving for their retirement until the college years are over, because doing so would mean missing out on years of tax-deferred growth and, possibly, employer-matching 401(k) plan contributions.

The key to saving for both is for parents to tailor their monthly investment to the particular investment goal — college or retirement. Parents will then need to determine their time frames and liquidity needs for each goal, which may require the assistance of a financial planning professional.

IMPORTANT DISCLOSURES

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